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COMMONWEALTH OF PENNSYLVANIA

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May 9, 1994

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Mr. William F. Caton
Acting Secretary
Federal Communications
Commission
1919 M Street, N.W.
Room 222
Washington, DC 20554

Re: Price Cap Performance Review
For Local Exchange Carriers
CC Docket No. 94-1

Dear Mr. Caton:

Enclosed please find an original and nine copies of the Comments of the Pennsylvania Office of Consumer Advocate, for filing with the Commission in the above-referenced matter.

Please indicate your receipt of this filing on the additional copy provided and return to the undersigned in the enclosed self-addressed, postage prepaid, envelope. Thank you.

Sincerely yours,

Philip F. McClelland
Assistant Consumer Advocate

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UNITED STATES OF AMERICA
BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION

IN THE MATTER OF:	:	CC Docket No. 94-1
	:	
PRICE CAP PERFORMANCE REVIEW	:	
FOR LOCAL EXCHANGE CARRIERS	:	

COMMENTS OF THE
PENNSYLVANIA OFFICE OF CONSUMER ADVOCATE

Philip F. McClelland
Assistant Consumer Advocate

For:
Irwin A. Popowsky
Consumer Advocate

Office of Attorney General
Office of Consumer Advocate
1425 Strawberry Square
Harrisburg, PA 17120

DATED: May 9, 1994

I. INTRODUCTION

On February 16, 1994, the Federal Communications Commission issued a Notice of Proposed Rulemaking ("Notice") and solicited comments concerning the performance of Price Caps for Local Exchange Carriers ("LECs") and potential for revisions to the current price cap regulations. The Pennsylvania OCA ("PaOCA") submits these comments in response to that Notice.

In summary, the PaOCA offers the following recommendations:

- The existing FCC price cap offset should be increased to better reflect declining costs in the provision of telecommunications service.
- It is unnecessary and inappropriate to charge excessive rates on non-competitive services in order to subsidize development of infrastructure improvements.
- The FCC earnings sharing mechanism should be retained.
- Rates for new services must continue to be based on a reasonable allocation of costs.

II. INTEREST OF PENNSYLVANIA OFFICE OF CONSUMER ADVOCATE

The PaOCA is an office created by the Pennsylvania General Assembly to represent the interests of consumers before state and federal agencies and courts which regulate the activities of Pennsylvania public utilities. 71 Pa. Stat. Ann. § 309-4(a). The Commission is now proposing to reconsider its price cap regulations. Many of the LECs subject to price caps provide service in Pennsylvania, specifically to residential consumers. Also, many Interexchange Carriers provide service to Pennsylvania consumers, purchase price capped interstate services from LECs and pass those costs through their rates charged to consumers. PaOCA believes that Commission review and revision of its price cap plans will have an impact on the consumers which the PaOCA represents. Thus, the PaOCA files these Comments.

III. PRESENTATION OF COMMENTS

A. Introduction.

The PaOCA proposes that the price cap mechanism should be revised so as to make certain that the mechanism reflects the declining cost nature of the industry and that those declining costs are reflected in reduced rates.

PaOCA emphasizes one point above all others. For many services provided by the LECs throughout the greatest portion of their service territories, the LEC's retain monopoly power as the primary if not the sole provider of these services. Despite the great attention given to emerging competition for some LEC services in some locations, the Commission must continue to recognize the maintenance of the present LEC monopoly for many services. As long as that monopoly power remains intact, the Commission must act to protect consumers from excessive monopoly rates.

A recent quote in the New York Times from Chairman Reed Hundt emphasized this point. Chairman Hundt discussed criticisms of the then recent Commission announcement that cable company rates would be reduced by an average of 7%. He stated as follows:

> I don't think that there is any question but that the national information infrastructure is going to be a magnet for investment.
>
> . . .
>
> But it should not be built by obtaining unreasonably high, unfair, monopolistic prices from customers.

New York Times, February 25, 1994. The PaOCA believes that this comment is precisely the point. To the extent that effective competition does not yet exist in either telecommunications or cable television services, the pricing of those services cannot be unrestrained. The least economical and least equitable manner in which to finance the new information infrastructure is by forcing monopoly ratepayers to pay excessive rates on non-competitive services.

B. The Price Cap Offset Should Be Increased.

The Commission has noted that telecommunications technology has changed, leading to the availability of new services and increased usage. Notice at ¶ 2. The Commission suggests that earnings have been higher than would have been the case under rate of return regulation and that the goal of price caps is to make certain that rates are reasonable and "lower than under rate of return regulation." Id. at ¶¶ 9 and 12. Although cumulative inflation over the 1989-1992 period has been 11.6%, access rates are currently $1.6 billion less than they were at the beginning of price caps. Id. at ¶ 12. At the same time, the Commission indicates that LECs had achieved an average overall rate of return of 11.25% when price caps were initiated, but now have achieved a comparable 12.25%. Id. at ¶ 44. All the while, however, much modernization has continued to occur. PaOCA suggests that these facts, taken as a whole, strongly support the determination that telecommunications is a declining cost industry even as modernization continues and accelerates.[1]

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[1] PaOCA does not suggest that it is possible to draw a causal connection between price cap regulation at the federal level and the profitability and modernization achievements of the LECs.

PaOCA most strongly supports the Commission's determination that price cap regulation should attempt to assure "that productivity and efficiency gains are shared with ratepayers." Id. at ¶ 31. The benefits of the declining cost nature and technological advances of the industry must be shared with the consumer in order for this regulatory regime to be fair and equitable. Most appropriately, as the Commission suggests, the national economy benefits if these gains are passed through in the form of lower telecommunications prices. Id. It is entirely inappropriate and unnecessary to allow the LEC to realize massive excessive profits on non-competitive activities.

It is also important to emphasize that protection against excessive monopoly profit is a necessary aspect of any regulatory model designed to replicate a competitive market and its pricing. This was discussed in some detail in a recent study of regulatory methods as follows:

> One other feature of perfect competition contributing to its acceptance by noneconomists as a regulatory guide is the profit level implied by equilibrium in a perfectly competitive market. As is emphasized in every economics textbook, in such an equilibrium the firm is condemned to earn (no more than) zero economic profit, and it can only attain this level of profit - that is, it can avoid outright loss - by achieving perfect efficiency in its operation and by charging prices sufficiently low to avoid

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PaOCA emphasizes that roughly 75% of LEC regulated activity is regulated by the states which have maintained a variety of regulatory methods over the period studied. Nonetheless, PaOCA submits that the data used by the Commission in its Notice suggests that federal price cap regulation has not interfered with the profitability and modernization activities of the LECs.

> driving its customers into the arms of its rivals. The zero-economic-profit requirement is not so draconian as it sounds, because it is defined to include gross earnings sufficient to pay interest to those who have lent funds to the firm and to provide a return to equity holders that is consistent with the prevailing level of interest payments, after adjusting for differences in the risk of debt and equity. Nevertheless, this level of earnings permitted by competitive-market forces limits earnings to what is called the cost of capital, or to what regulators traditionally have called a "fair rate of return." In other words, besides serving as an instrument for attaining economic efficiency, perfect competition promises fairness by its preclusion of profits that might be deemed excessive. This guarantee of fairness, then is another reason for the widespread acceptance of the competitive-market standard for regulation.

W.J. Baumol and J.G. Sidak, Toward Competition in Local Telephony 30 (1994) (footnote omitted). This hallmark of competitive markets, i.e. the limitation of profit levels to those experienced under competitive conditions, must continue to be emphasized in the consideration of the appropriateness of any regulatory method such as price caps.

Given the rate reductions and continued strong returns experienced by the LECs, PaOCA supports the Commission's suggestion that "we believe that there may be a good case for revising the 3.3 percent and 4.3 percent productivity factors, requiring a one-time reduction in rates or both." Id. at ¶ 45.

The existing 3.3% and 4.3% inflation offsets are inadequate and understated. PaOCA notes that in a recent Pennsylvania proceeding concerning the proposed application of a price cap formula to Bell Atlantic - Pennsylvania, Inc. before the

Pennsylvania Public Utility Commission, the PaOCA advocated a 6.0% inflation offset.[2] This recommended price cap offset was composed of a productivity differential, comparing the low end of the total factor productivity of Bell Atlantic vs. the United States economy as a whole, of 2.5% to 3.4%; an input price differential, comparing the Bell Atlantic - Pennsylvania experienced input prices vs. the United States economy of 2.0%; and "the stretch factor" applied to reflect the likelihood of increased productivity for Bell Atlantic - Pennsylvania in the future of 1.5%. Id. In the Recommended Decision issued in that case on April 28, 1994, the three Administrative Law Judges have recommended to the Pennsylvania Public Utility Commission the use of a price cap formula of GDP-PI - 5.29%. Recommended Decision at 183. Also, in the March 7, 1994 Proposed Decision in the Application of GTE California, Inc. and In the Matter of the Application of Pacific Bell, et al., A. 92-05-002 et al., P.D. 94-03-07, slip op. at 9-46, before the California Public Utility Commission it was determined by the ALJ that a price cap formula of GDP-PI - 6.0% should be applied. Thus, it would be appropriate for the FCC to increase the inflation offset consistent with recent data reviewed by the PaOCA and used by the administrative law judges in Pennsylvania and California.

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[2] Bell Atlantic - Pennsylvania's Petition and Plan for Alternative Form of Regulation Under Chapter 30, Docket No. P-00930715 (Bell Atlantic - Pa. Petition), PaOCA testimony of Dr. Marvin Kahn, Statement 2 at 35.

C. <u>Raising Rates Pursuant To The Price Cap Mechanism In Order To Promote A National Information Infrastructure Is Unnecessary And Inappropriate</u>.

The Commission has requested information as to whether the price cap mechanism should be revised in order to support the development of a ubiquitous national information infrastructure. <u>Id.</u> at ¶ 15. Also, the Commission requests information as to the rate at which LECs are replacing copper with fiber and using compression to provide video services. <u>Id.</u>

The PaOCA concludes that it is not necessary to increase rates under the price cap mechanism so as to allow greater profitability of LECs. Most notably, Bell Atlantic has previously announced in December 1993 that it will construct a video capable network which will serve 1.25 million homes by the end of 1995, its top 20 markets by the end of 1998 and 80% of its customers by the end of 2001.[3] Thus, Bell Atlantic intends to rapidly provide an advanced infrastructure for its customers and has planned on this for some time. PaOCA emphasizes that this pace of deployment does not appear to be dependent in any manner on a revision to the Commission price cap mechanism.

PaOCA bears in mind the Separate Statement of Commissioner Barrett attached to this Notice of Proposed Rulemaking which notes: "I am concerned that the regulatory mechanism must provide incentives for telephone companies to invest in more risky

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[3] Phila. Inquirer, Dec. 2, 1993, at C8 *Linking TV, phone industries*. Also confirmed by deposition of Bell Atlantic, Inc. Vice President of Broadband Multi-media Network Implementation, Denny Hylton on Dec. 2, 1993 in <u>Bell Atlantic - Pa. Petition</u>.

endeavors in the marketplace while requiring that the companies bear the burdens associated with the increased risks rather than subsidizing the new endeavors at the expense of customers who do not want such services."[4] The PaOCA also believes that the LECs wishing to make such deployment should bear the risk, and opposes any revision to the price cap formula which would effectively raise rates above the level that would otherwise occur under the formula simply to fund a broadband network. This approach may very well subsidize broadband networks out of the pockets of customers not interested in buying such services. In any event, it would be inequitable to require monopoly customers not requesting such services from their LEC to be required to pay for them.

D. The Earnings Sharing Mechanism Should Be Retained.

The Commission has requested comments concerning whether the present earnings sharing mechanism should be retained and, if so, how it may be modified. Notice at ¶ 55. The PaOCA advocates that the Commission should retain the earnings sharing mechanism. As the Commission indicated in its Notice, the earnings adjustment mechanisms were adopted "[i]n recognition of possible errors in the productivity factor and variations in the productivity of the LECs . . . ." Id. This same concern is equally as applicable now as it was when price caps were initiated.

As the discussion immediately preceding makes clear, many of the LECs will be rebuilding much of their present networks in order to provide video services. It is possible that significant

[4] Separate Statement of Com. Barrett at 2.

productive economies will be realized as a result of these modernization improvements. At the present time it is difficult to project the extent of this increased productivity with a large degree of certainty. As the various LECs deploy optical fiber in the distribution networks and compression over copper networks to differing degrees, the productivity encountered by various LECs may diverge dramatically. Thus, it also becomes difficult to construct the same fixed price cap inflation offset, apply it to all LECs and hope to properly share the productivity improvements achieved by each LEC with its customers.

In this context, it is reasonable to retain an earnings sharing mechanism as a form of a regulatory backstop to assure an appropriate sharing of productivity improvements between LECs and their customers. The PaOCA emphasizes that such an earnings sharing mechanism should not be a strict limitation to return all earnings above a calculated cost of capital. The PaOCA supports the use of a 50% sharing mechanism as an appropriate method of applying any earnings sharing method.

E. <u>The Commission Should Retain The Requirement That Pricing For New Services Must Consider Costs</u>.

The Commission has also requested comment on the extent to which it should reduce its requirements for making certain that services recover their costs. Notice at ¶¶ 73-83. Current pricing rules for new services require that cost data must be submitted in order to make certain that services cover their direct costs and a level of overhead costs. <u>Id.</u> at ¶¶ 75-76.

PaOCA supports continuing to require cost support, including an overhead allocation, to be provided for all new services. This requirement is all the more necessary as LECs begin to market broadband services in competition with existing service providers.

In its discussion of price baskets, the Commission has noted:

> Separating services subject to differing levels of competition into separate baskets and service categories hinders the LECs' ability to increase prices of less competitive services so that the LECs can decrease prices of more competitive services without a concomitant revenue loss.

Id. at ¶ 38. Thus, the Commission has been justifiably concerned with the potential for adjusting prices on some existing services so as to reduce prices on more competitive services. This concern should be equally as important with the offering of new services into a more competitive market. It is important to make certain that new services are actually covering their direct costs and a fair share of joint and common costs such as overhead.

The PaOCA has been active in a number of Bell Atlantic video dialtone filings on this point. Notably, Bell Atlantic has advocated that it will construct broadband networks with fiber to the curb architectures but has been reluctant to assign a reasonable proportion of the cost of the fiber trunks necessary to provide video services to these services.[5] PaOCA is concerned

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[5] In The Matter Of The Applications Of The New jersey Bell Telephone Company For Authority Pursuant To § 214 To Provide Video Dial Tone Service, File Nos. W-P-C 6838 and 6840. On April 21,

that, if no cost support is required for the tariffing of new services, LECs will have strong incentives to subsidize new services by not fairly reflecting their costs in the pricing of those services. Thus, PaOCA encourages the Commission to retain these cost requirements for pricing new services to prevent potential cross-subsidy and competitive harm.

1994, the PaOCA filed an ex parte presentation "Allocation and Separation of Broadband Loop Costs Installed by Telephone Companies to Provide Video Dial Tone Services" addressing this point in those proceedings.

IV. CONCLUSION

The Pennsylvania Office of Consumer Advocate proposes that the Federal Communications Commission should adopt the recommendations set forth above.

Respectfully submitted,

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DATED: May 9, 1994
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